www.pwc.com/pensions

International pensions require local solutions

PwC's view on international pension trends, based on a review of the IAS 19 pension disclosures of large listed companies in Europe.

December 2015

Table of contents

1. The impact of pension liabilities on business varies by territory
2. Pensions are still highly volatile
3. Cash is spent, but funding levels go down

Summary

We have conducted an investigation into the IAS 19 disclosures of large listed companies in Europe. The investigation covers disclosures from 2014 and 2013, and the latest developments during 2015.

Our main conclusion is that pension liabilities remain highly volatile across Europe, even allowing for the trends to reduce risk (at least for future accrual). Pension costs are even more volatile and large cash payments have repeatedly failed to prevent a fall in funding levels.

The good news is that there are options available for companies that make a concerted effort to solve the problem, beyond just paying in more cash. Since a large part of pension liabilities come from foreign subsidiaries, it is essential that companies realize that real-world cross-border actions are needed to address and resolve their pension issues.

Our survey covers companies with a market cap above €1bn. To include a country in the survey, we have also set a limit that they must have at least 25 companies above that market cap. The survey thereby covers France, Germany, Italy, Netherlands, Sweden, Switzerland and UK.

If you would like to discuss the issues and findings included in this report or their impact on your business, contact details can be found at the back.

"Pension liabilities and costs remain highly volatile, but options to solve pension issues are available for companies that make a concerted effort cross-border"

Country	*Number of companies*	*Defined Benefit Obligation (DBO)*	*Market Cap*
France	111	291	1,404
Germany	106	433	1,360
Italy	45	34	360
Netherlands	28	170	427
Sweden	51	51	475
Switzerland	71	204	1,267
UK	175	798	2,226
Total	**587**	**1,981**	**7,518**

amounts in € billions

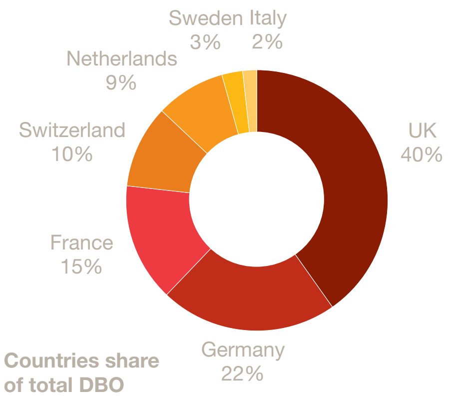
1. The impact of pension liabilities on business varies by territory

There are ways to tackle issues related to pension liabilities, but the solutions vary between countries. As the pension issues arise cross-border, domestic solutions are for most multinational companies not enough to reduce their risk profile.

"Multinationals suffer from international pension issues, but require local solutions"

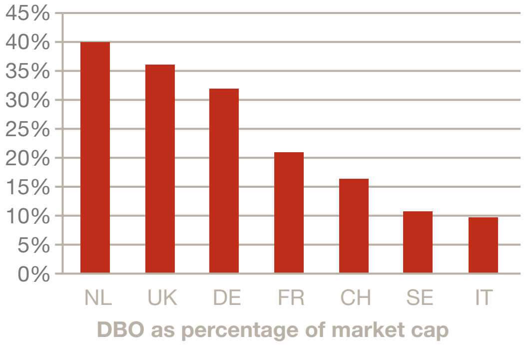
"Various solutions are available in UK, but these need to be employer-led as Trustees are conflicted by their statutory roles"

Largest liabilities in UK, Germany and France



Within the compass of our investigation, we see that the country with the largest pension liability (DBO) is UK, followed by Germany and France. Switzerland and Netherlands also have significant liabilities whereas the liabilities in Sweden and Italy are relatively small in comparison.

Netherlands, UK and Germany have the largest liabilities compared to market cap



We have also compared pension liabilities to the market cap of the company that backs them, which further confirms that UK and Germany are among the countries where the pension issues are most significant, but on this measure the greatest strain is in the Netherlands.

The graphs are based on where companies are listed, and does not necessarily show in which countries the liabilities are concentrated. Multinationals have cross-border pension issues where liabilities to a large extent are foreign. In a previous investigation conducted in the Netherlands we concluded that two thirds of the liabilities for large Dutch companies related to subsidiaries abroad.

Based on our experience, UK and Germany are countries where to a larger extent liabilities come from domestic entities, but certainly not solely. The possibilities to tackle issues with the pension liabilities vary between countries.

In the UK, pension increases are a fixed promise and cutting benefits is not an option. To address the UK challenge, detailed analysis is needed to identify subsections of pension plans that can be tackled in a cost-effective way. It is rare to have a single solution that can remove UK pensions from the balance sheet.

Potential solutions in the UK are focused around offering members alternative forms of benefits, for example transferring their pension rights to a more flexible DC arrangement, or reshaping benefits to exchange pension increases for a higher level pension. These offers need to be employer-led, as pension fund Trustees are generally conflicted by their statutory roles.

There are also possibilities to find cost-effective insurance solutions, based around identifying market opportunities for arbitrage for specific groups of members, or constructing internal hedges to protect the company from volatility.

In Germany pension plans are often unfunded (i.e. no plan assets are set aside to pay promised benefits) which makes the liabilities and cash costs more volatile. Analysing this volatility and monitoring cash costs are two ways to get a measure of control over this, but there are also new innovative possibilities to reduce liabilities in Germany.

In the Netherlands we have seen a significant amount of risk reduction in recent years, as a growing number of companies are switching from DB to DC plans (or at least plans that are accounted for as DC, but still give members some of the benefits of DB).

It is essential that companies realize they will need a concerted effort on the part of their entire international network with respect to pursuing pension reform - changes to domestic plans alone will not suffice.

2. Pensions are still highly volatile

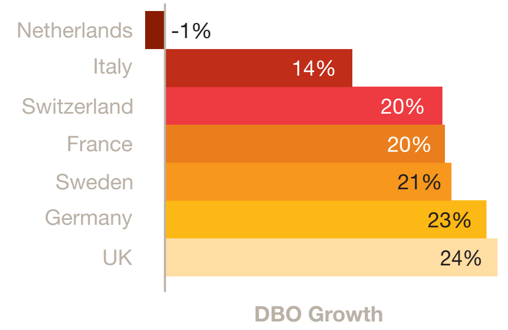
Although there has been a trend to move from DB to DC, at least for new accrual, there are still challenges when it comes to managing balance sheet volatility. Significant pension liabilities hurt company's solvency ratios and covenants.

"Pension liabilities are increasingly volatile, hurting company's solvency badly. Pension costs in P&L are even more volatile"

"The real risk of a €100m deficit in a Dutch insured plan is different to an equal deficit in a UK fully indexed final pay plan"

"Dutch pension regulation allows risk reduction to a certain extent. Actions taken by management have significantly reduced liabilities in the Netherlands"

Strong growth in liabilities compared to last year, except for the Netherlands



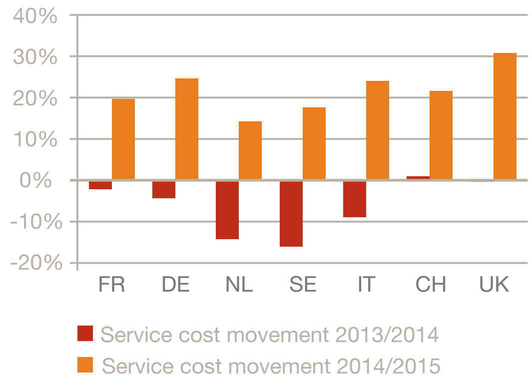
Most pension liabilities are extremely volatile: during the last year DBO increased by more than 20% in five out of seven countries in our investigation. The main culprit is once again falling discount rates, within the Eurozone and most other territories.

In Italy, the impact is smaller, as pension promises mainly arise from lump-sum payments (and not lifelong retirement pensions). This shorter horizon protects Italian plans from long-term interest rate shocks.

In the Netherlands there was a minor decrease in DBO over the last year – but this doesn't tell the whole story. The fall is driven by those companies that have settled part or all of their existing pension liability, through various actions taken by management – e.g. changes to funding arrangements and pension plans.

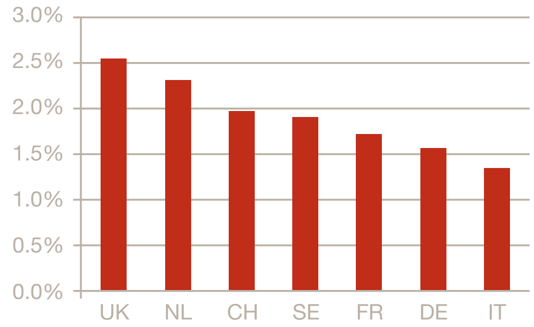
Not all territories have the scope and flexibility of the Netherlands when it comes to tackling pension deficits. A further complication exists because IFRS deficits have different 'real-world' significance in different territories – the 'real' risk of a €100m deficit in a Dutch insured plan is different to an equal deficit in a UK fully indexed final pay plan.

Rollercoaster pension cost



The volatility does not only impact the pension liability. The service cost (cost of accrual) recognised in P&L is even more volatile. In general, large service cost increases are expected in 2015 (compared to 2014) in comparison to a smaller decrease in most countries between 2013 and 2014.

Service cost as a percentage of DBO



Service cost as a percentage of existing DBO is quite low across all countries, reflecting that new accrual for many businesses is made through DC plans rather than DB plans (or by moving business to "non-pension" countries in Eastern Europe, Asia or Africa). By doing this companies avoid making the pension liability issue larger, but they still haven't found similar success in dealing with legacy obligations.

Businesses therefore need to assess whether the DB plans are meeting their HR objectives and if they can continue to do so at an acceptable cost, or otherwise what the possibilities for change are.

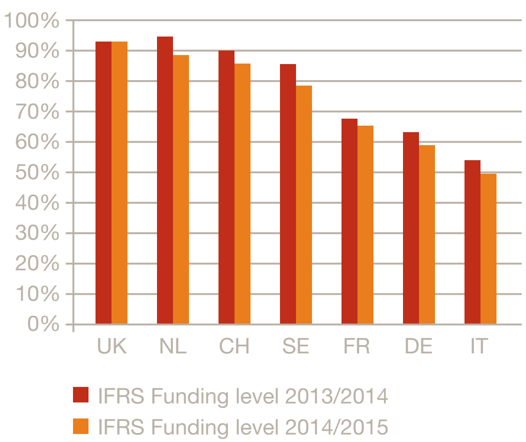
**The actions which reduced the liability in the Netherlands include switching from DB to CDC plans, IFRS-proof pension contracts or DC plans.
These solutions are common in the Netherlands, but negotiations with unions/works councils are usually required to be able to redesign the plans, through for instance removal of unconditional indexation and the link to final pay, or agreeing on a DC plan for future accrual. This moves the risk from the employer to the insurance providers and/or the employees.**

3. Cash is spent, but funding levels go down

Despite the huge payments of corporate cash into plans to try to pay down past deficits, the gap has only gotten bigger. Real-world actions are required to change this trend.

As shown below, the funding levels (Plan assets vs DBO) fell in almost all surveyed countries during the last year - despite €45bn of cash payments put in to the schemes over 2014. Asset mismatching and falling interest rates have driven liabilities up higher than asset returns and cash contributions could match.

IFRS Funding level the last two years



"Cash payments are strongly affected by statutory funding requirements"

The funding levels vary a lot between the countries, with UK, Netherlands and Switzerland as the countries with the highest funding levels. In all of these countries it is common that pension schemes needs to be fully funded under statutory rules, which may require significant cash payments in certain years. In many regimes, the IAS 19 liability is higher than the statutory funding requirement – meaning even fully funded schemes show a deficit under IAS 19.

In the UK, the funding regime is more demanding – even once the plan is fully funded for IAS 19 purposes, the rules will still demand further cash payments.

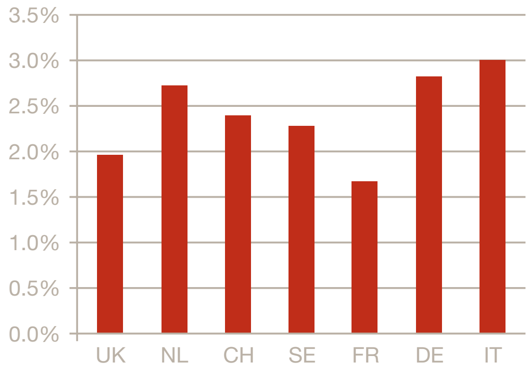
For France, Germany and Italy the funding levels are low, which is due to that many schemes in these countries are unfunded. Unfunded pension schemes is the case in particular in Germany, in Italy and France there are mainly unfunded termination/severance indemnities. In unfunded schemes, benefit payments to pensioners needs to be met by cash payments from the company. As shown in the graph to the right, Italy has the highest cash payments as a percentage of DBO, followed by Germany.

The funding level in Sweden is quite high which is explained by a large part of foreign liabilities - there is usually no minimum funding requirement for Swedish liabilities (which can also be unfunded).

"Plunging cash into pension plans doesn't help, real-world actions are needed"

In comparison to the graph on the previous page, showing service cost as a percentage of DBO, we note that employer cash contributions are higher than the service cost in all countries except UK.

Employer cash contributions as a percentage of DBO



The graphs emphasize what we have mentioned before. Although new accrual in the plans is low there are still issues related to volatility in cash and funding level, and the 2014 cash payments of €45bn have been a waste of money from that perspective.

Real-world cross-border actions are therefore needed to address the pensions problem. Possibilities are available for companies that make an concerted effort to solve the problem.

Contact details

PwC has a successful track record in addressing corporate pension challenges given the scope and depth of our commercial, financial, legal, HR and pensions expertise. If you wish to discuss the information contained in this document or the ways in which we can help you, please call your regular PwC contact or alternatively contact:

PwC Netherlands:
Mischa Borst
+31 (0) 8879 27457
mischa.borst@nl.pwc.com

PwC UK:
Brian Peters
+44 20 7212 3353
brian.s.peters@uk.pwc.com

PwC Switzerland:
Adrian Jones
+41 58 792 4013
adrian.jones@ch.pwc.com

PwC France:
Hélène Farouz
+33 (0) 1 56 57 61 02
helene.farouz@fr.pwc.com

PwC Germany:
Bernd Hackenbroich
+49 211 981 2882
bernd.hackenbroich@de.pwc.com

PwC Sweden:
Anna Gustring Boman
+46 (0) 10 212 48 86
anna.gustring.boman@se.pwc.com

PwC Italy:
Alberto Umena
+39 346 227 83 23
alberto.umena@it.pwc.com

PwC Spain:
Javier Lopez Otaola
+34 915 685 744
javier.lopezotaola@es.pwc.com

PwC Belgium:
Monique Mariamé
+32 2 7107115
monique.mariame@be.pwc.com

PwC Ireland:
Munro O'Dwyer
+353 (1) 792 8708
munro.odwyer@ie.pwc.com

PwC Finland:
Markku Kukkala
+358 20 787 8215
markku.kukkala@fi.pwc.com

PwC Denmark:
Jette Lunding Sandqvist
+45 3945 3817
jls@pwc.dk